STATEMENT OF

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Good morning, Mr. Chairman and members of the Subcommittee. My name is Victoria Harker. I am the Chief Financial Officer of the MCI Group, an operating unit of WorldCom. I am honored to have this opportunity to testify before the Subcommittee on a very important issue: ensuring the continued sufficiency and stability of the universal service fund (USF).

This issue would probably not command your attention but for the dynamic changes that have transformed the telecommunications marketplace in the last few years. The benefits for consumers have been enormous. Spurred in large measure by the historic Telecommunications Act of 1996, tremendous changes and opportunities have been experienced since its enactment. Technological convergence and product bundling are now two of the hallmarks of our industry.

MCI, of course, has been an instrument of change. More than 30 years ago, MCI pioneered competition in the long distance industry. Now a part of WorldCom, MCI is no longer just a long distance company. Among other things, we are now the largest competitive provider of local services in the United States.

In fact, MCI recently launched *The Neighborhood*, a new set of national consumer products that serve to fulfill the vision of the 1996 Act. Our flagship product, *Neighborhood Complete*, is the first residential product that combines unlimited local and long distance voice service plus features such as call waiting, caller ID and voice mail – all in one package for one flat monthly fee ($49.99 or $59.99 monthly, depending upon the customer's location). Consumer response has been tremendous. We didn't stop there. Last week, we also launched a similar program for small businesses – *Business Complete*.

We are proud of our pro-competition legacy. When MCI brings industry-leading products to market, all customers benefit. In this context, change is clearly good. But industry change, while good for consumers, now threatens the sustainability of universal service.

Universal service has been an essential feature of U.S telecommunications policy for almost a century and has benefited all Americans by extending the public switched network to rural communities and to low-income households and by supporting schools, libraries, and rural health care facilities. Adequate universal service support for these important programs and activities must be maintained. Given the rapid changes in the marketplace, however, the current funding mechanism must be reformed immediately to assure three critical policy goals: the fund's continued sustainability, competitive neutrality and administrative efficiency. The existing funding mechanism fails to meet any of those three goals.

In constructing the 1996 Act, Congress recognized that a major source of universal service support – revenues generated by above-cost access charges – could not be sustained if its overarching goal of competitive telecommunications markets were to be achieved. Congress therefore required the Federal Communications Commission (FCC) to reform both access charges and the universal service funding mechanism. It directed the FCC to replace the implicit subsidies with specific, predictable, and sufficient universal service funding mechanisms that telecommunications providers contributed to on an equitable and nondiscriminatory basis.

When the FCC first acted in 1997, interstate and international telecommunications revenues had been growing steadily for more than a decade. Except for the case of wireless offerings, interstate and international services were not being bundled with intrastate or information services and thus represented a stable and growing assessment base that was relatively easy to identify and measure.

This made possible a system for assessing and collecting universal service funds from carriers based on historical revenues. Carriers are required to report their interstate and international revenues on a periodic basis. The FCC estimates the total amount needed for the fund for a forthcoming period and, dividing that need by the total assessable industry revenues reported, calculates a "contribution factor" (currently 7.28%) that is applied to each carrier's reported revenues to determine the dollar amount owed by each carrier. Carriers recover their universal service costs from customers.

Problems arose, however, as market conditions changed. As I shall discuss in greater detail below, the sustainability of this revenue-based mechanism has been threatened as competition from products not subject to the assessment has substantially and irreversibly reduced total interstate and international telecommunications revenues. Moreover, the revenue-based assessment mechanism proved not to be competitively neutral as markets converged and now-competing services are subject to different levels of universal service assessment.

WorldCom participates in a coalition of telecommunications carriers and users that is proposing that the FCC change the current mechanism to an assessment on all connections to the public network. For reasons I'll explain, our coalition proposal is the only one that achieves the three policy goals of sustainability, competitive neutrality, and administrative efficiency. It has an additional advantage – it can be implemented immediately.

THE EXISTING FUNDING MECHANISM IS NOT SUSTAINABLE

Changes in the marketplace are driving the need for reform of the USF funding mechanism. While these changes, by and large, have been very beneficial to consumers and business users, they pose a significant threat to the future sufficiency and stability of the universal service program. Time is of the essence. In the context of universal service policy, he who rejects timely and meaningful change is an architect of destruction.

The universal service funding mechanism that worked well just five years ago now faces a death spiral. The rapid growth in interstate and international telecommunications revenues in the late 1990s has been replaced by sustained annual decline (see Chart 1). Quarterly revenues have dropped nearly 12% from their peak of $21.2 billion in 1999 to just $18.7 billion in the first quarter of 2002. E-mail and instant messaging have replaced many long distance calls. Internet searches are used as a substitute for 800 calls. Of course, wireless service packages with "free" long distance have contributed enormously to this fundamental market change. Although not yet a major factor, voice over the Internet will soon have a significant impact on interstate and international revenues.

At the same time, it is becoming much more difficult to identify assessable revenues as customers demand that providers offer bundles of interstate and international telecommunications services, intrastate telecommunications services, information services, and even customer premises equipment priced in a fashion that does not explicitly measure the interstate and international telecom revenues generated. There is no simple way to measure assessable revenues for bundled products. Bundling started with wireless products but has since moved to local and long distance bundles offered by the Bell monopolies and competitive companies. The problem is even more complex for large business customers who negotiate contracts for the purchase of services and equipment that can exceed $100 million a year. As USF charges assessed to businesses approach 10 percent, these enterprise customers have a growing incentive to "bypass" the system to minimize the portion of revenues subject to the assessment, including a migration toward Internet solutions that could significantly reduce their universal service burden.

This creates a vicious cycle. As the current assessment base declines, the assessment rate on remaining interstate and international telecommunications revenues continues to grow, further encouraging customers to shift their purchasing decisions toward services that either are unassessed (e.g., voice over the Internet) or under-assessed (e.g., wireless). Residential customers have fewer opportunities for avoidance and will likely bear the brunt of this cycle. Most residential customers are already being assessed at least 9.9% of their interstate bill and will likely face even higher assessments unless a more rational approach is adopted. Prompt reform of the existing funding mechanism is an urgent necessity.

Although interstate telecom revenues are declining, customers still must connect to the public network. Fortunately, connections to the public network are stable and growing. For that reason, WorldCom and its partners in the Coalition for Sustainable Universal Service (CoSUS) have submitted a detailed funding mechanism proposal to the FCC that would assess the provider of every customer connection to the public network.

EXISTING FUNDING MECHANISM FAILS COMPETITIVE NEUTRALITY TEST

The current funding mechanism was created before local, long distance, and wireless markets began to converge, and thus it had little competitive impact on the marketplace. Today, however, several imperfections in the mechanism have a glaring impact on the marketplace. When the Commission could not identify the proportion of wireless service that was interstate a few years ago, it created a temporary 15 percent “safe harbor” for wireless carriers based on the proportion of local exchange carrier (LEC) traffic that was interstate in nature. Wireless carriers therefore bear a federal USF assessment on, at most, 15 percent of their revenues. As we all know, however, the major wireless carriers concentrate their marketing efforts today on regional and national calling plans that provide large buckets of all-distance minutes for a fixed monthly rate. Many customers increasingly use these plans for long distance calling. These service offerings compete directly with both the long distance and all-distance offerings of wireline carriers. Because their services are subject to much lower universal service assessments, wireless carriers are provided with an artificial market advantage.

Similarly, international carriers with no or minimal interstate revenues enjoy an advantage over carriers that offer domestic as well as international services because they are exempt from the universal service assessment. For example, a carrier with mostly international revenues (such as Loral Space Communications or Lockheed Martin) that does not have to contribute to universal service would be able to provide a customer with a service offering free of any universal service surcharges, while WorldCom would have to charge that same customer a universal service recovery fee. This obviously provides some of our international competitors with a significant yet artificial advantage.

Also, because the current mechanism assesses carriers based on their actual revenues six months earlier, it disadvantages traditional long distance carriers vis-à-vis wireless and local carriers, particularly those Bell companies that are now entering the long distance market for the first time. Traditional long distance companies are experiencing sharp declines in interstate revenues. Wireless carriers and Bell companies gaining entry into the long distance market, on the other hand, are experiencing substantial increases in interstate revenues. Long distance companies are forced to increase the federal universal service fee on customers' bills to recover fully their USF obligations, while the Bells and wireless carriers enjoy a windfall simply by charging their customers the FCC's assessment rate on a growing base.

While it is important to remove these anticompetitive distortions in the market, simply correcting these competitive imbalances would not achieve the other two policy goals -- sustainability and administrative efficiency.

THE COSUS PLAN IS THE ONLY ONE THAT ACHIEVES ALL POLICY GOALS

Under the CoSUS proposal, every telecommunications carrier and private carrier would pay universal service contributions based on the number of interstate or international connections to the public network that it provides to end users. The assessment would vary based on customer class and capacity, rather than on the technology used to provide service, so that carriers offering services that compete with one another would be assessed at the same rate. Initial rates would be set as follows:

- $1.00 per residential line, single-line business, and non-paging wireless connection. Lifeline connections are exempt.
- $0.25 per paging connection.
- Approximately $2.75 per switched multiline business connection, determined as follows: during a one-

year transition period for carriers to develop tracking, reporting, and billing systems for high capacity connections, the contribution for private line and special access connections would remain the revenue-based contribution percentage in effect for the last quarter under the current mechanism. Switched lines would then be assessed on a per connection basis to cover the residual between the fund size and the other USF funds generated. Centrex lines would be assessed one-ninth the basic switched access line rate.

Switched connection providers (LECs and wireless carriers) already have a line item for universal service recovery, so billing systems changes are not needed other than to change the amount of the USF fee. After the one year transition period, per connection multiline business connection assessment rates would be established based on the total contribution that would have been collected from the combination of switched multiline business and private line/special access connections had the transition continued. That total contribution would be collected through simple capacity-based charges, relying on the long-standing industry categories of DS0, DS1, and DS3 to assign greater weight to higher-capacity connections. Going forward, depending on the growth of the fund size relative to the growth in the number of (weighted) connections, all assessment rates would increase or decrease in uniform proportion.

Under the CoSUS proposal, the impact on consumers will be positive. Lifeline customers would pay no universal service fees. Residential customers across all income groups would pay less, on average, in universal service fees under the CoSUS proposal than under either the current revenue-based mechanism or the proposal advocated by SBC and BellSouth (see Chart 2). In addition, a single per-connection charge will be much more understandable and more uniform for similar services, simplifying the customer task of comparing alternative offerings.

Carriers would pay contributions on a collect and remit basis that is analogous to the efficient process used to collect the federal excise tax. The CoSUS proposal can be implemented without the FCC first determining how it intends to define and regulate broadband providers; it can accommodate any FCC decision on that issue in other pending proceedings.

THE COSUS PROPOSAL WOULD ACHIEVE THE GREATEST ADMINISTRATIVE EFFICIENCY

It is essential that the assessment mechanism be as administratively efficient as possible because the cost of universal service funding is ultimately borne by telecommunications users. As explained earlier, it is no longer possible to identify readily which revenues are generated by interstate telecommunications services. By collecting assessments for any customer connection from the single provider of the connection to the public network, rather than from multiple intermediate service providers (long distance companies and ISPs), transaction costs are minimized.

A long distance company or Internet dial-up service provider will not know the particulars of the connection its customer uses to receive that service. In these cases, the customer's connection occurs via their local telephone wire. If MCI, for example, were assessed based on those connections (as proposed by SBC and BellSouth), my company would have to depend on data that only our customer's local exchange carrier possesses.

The industry and many customers learned from painful experience that it is cumbersome and expensive to create mechanisms to transmit that information from connection providers to intermediate carriers in a usable and auditable form. When implementing access charge reform, the FCC required the large ILECs to assess a per-line charge, called PICC, on long distance carriers. That charge varied according to connection characteristics – such as whether a residential line was a primary line or whether a business line was a Centrex line – for which only the ILECs had the relevant information. The IXCs could neither audit the charges they received from the ILECs nor determine the right amount to recover from their end-user customers. These large ILECs ultimately developed electronic systems to provide and update the connection information (for which they charged the IXCs), but they had no incentive to accurately maintain the data and thus the IXCs had to develop complex systems to compensate for errors in the data and to this day are forced routinely to issue credits to customers to offset charges billed as a result of inaccurate identification of customer line types.

As difficult as the PICC experience has been, the SBC-BellSouth proposal would be worse. Only the 13 or so very largest ILECs charged PICCs and therefore only they had to construct the electronic systems needed to provide the relevant line information to IXCs. Under the SBC-BellSouth proposal, all 1,300+ ILECs – most of which are very small – would have to construct the electronic systems. Moreover, the data they would have to provide – customer specific information on the capacity of connections, the number of Centrex connections, etc., -- is increasingly market-sensitive as recipient companies, like mine, become actual or potential competitors to the ILECs. ILECs, then, would have even stronger incentives not to provide the data that the IXCs would need in order to know how much to pay into the fund and how much to collect from individual customers.

These administrative costs could be as great as the assessments themselves and would have to be passed on to the customer. Moreover, many long distance customers have zero usage during a particular month and therefore do not generate a bill. If the long distance companies were assessed for each customer to which they provided service, they would have to send out bills to millions of zero-usage customers each month just to recover the universal service assessment.

By contrast, the provider of a customer connection to the public network will know the characteristics of the provided connection and already bills monthly for that connection. Therefore, it is administratively efficient for the universal service assessment to be imposed on the provider of that connection. In most cases today, that would be the incumbent local exchange carrier (ILEC). In many cases, though, the obligation would be imposed on a competitive carrier. For example, it is efficient to impose a USF assessment on WorldCom for each interstate private line connection we provide to our customers (even if the ILEC is providing the underlying access circuit to us) because we have all the relevant billing and line characteristic information. Similarly, it is efficient to impose a USF assessment on all the switched connections we provide to our residential and business customers, whether we use our own facilities, unbundled loops, UNE-platform, or resale. As noted earlier, WorldCom (including its MCI operating unit) is the largest competitive provider of local services.

The CoSUS proposal also would improve the efficiency of the universal service assessment process by implementing "collect and remit," by which carriers would only have to remit those universal service charges they actually collect. Rather than requiring carriers to perform "true-ups" lagged over the period of time necessary to determine which of their universal service revenues are uncollectible, carriers would simply report their connections and (subject to audit) their historical uncollectible rate for those connections, and pay into the fund accordingly. This not only eliminates the need for carriers to recover their uncollectible universal service charges from paying customers, but also eliminates the lag between setting and recovering the carrier's assessments.

LEGISLATIVE AND REGULATORY THREATS TO USF SUSTAINABILITY

While my testimony explains why the current system of USF funding is not sustainable, I also must add that certain proposed changes at the FCC and in Congress would also jeopardize the universal service system.

The FCC has proposed to eliminate the *Computer II* unbundling requirement for ILEC broadband Internet access services. Under current rules, the elimination of the *Computer II* unbundling obligation for broadband Internet access services could also exempt the ILECs from the universal service contribution obligation associated with those services. Not only would there be an immediate reduction in the contribution base, but the impact on the contribution base would only grow as the ILECs acted on their incentive to expand the scope of services offered through the contribution-exempt Internet platform.

Also, legislation pending before the Commerce Committee would have negative consequences for universal service. S. 2430, the Breaux-Nickles bill, is objectionable for many reasons, particularly the devastating impact it would have on telecommunications competition. My testimony today, however, addresses only its impact on universal service. The proposed legislation states that all providers of broadband services must be subject to the "same regulatory requirements, or no regulatory requirements" and that this policy must be implemented "without increasing regulatory requirements applicable to any provider of broadband service." Since non-LEC broadband providers do not currently contribute to universal service, the bill would seem to require the FCC to relieve the Bells of the current and future contribution requirements on their broadband services.

Under the current revenue-based mechanism, as the Bells shift more and more traffic to high speed data service, Internet access and IP telephony, the potential base for contributions to the universal service fund would decrease. This would further destabilize the USF and raise even greater concerns about the sustainability of its current programs, such as the high cost fund designed to keep rural subscribers on the network. In addition, under Breaux-Nickles, the contribution burden would fall increasingly upon those consumers with the most basic of telecommunications services.

CONCLUSION

WorldCom shares this Subcommittee's strong commitment to universal service. Irreversible marketplace changes render the current funding mechanism insufficient and unstable. Prompt action by the FCC is needed to avert disaster. Now is the time for the FCC to adopt an approach that makes an assessment on all connections to the public network. This is the only approach that will achieve three critical policy goals: fund sustainability, competitive neutrality and administrative efficiency.